THE INSTITUTIONAL INVESTOR

An Address By

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I am delighted to be here at the annual convention of those who play "the money game". Anything in our transitory society which survives its second year -- especially a conference -- is obviously "permanent" and successful. As I look around this vast audience I understand why Gil Kaplan has obtained an option on Madison Square Garden for next year.

You all are aware of the growing attention which financial institutions are receiving. Their growth and importance can be gauged roughly by our host's success with the "Institutional Investor" publication. It has grown from 56 to 120 pages in two years -- a sort of journalistic "go-go" performance. Of course my analysis is incomplete. I am not familiar with redemption problems for technical magazines.

These are startling -- incredible times -- not only for financial institutions and the securities markets, but for society generally. We are witnessing in so many areas of our life changes of such revolutionary proportions as to make meaningful absorption of current trends and understanding of future implications difficult.

Our society is increasingly sloganized. Complex problems are reduced to minutes of TV time and solutions come in capsules. The rising crime rate can be solved by "law and order" -- or by "law and order with justice". It is all in code -- shortened for convenience -- so that we need not think things through. We find convenient labels for the symptoms and ignore the underlying illness.

I have been in Washington for almost 27 years, serving under six presidents. Those years have spawned "frightening" events. Indeed, this entire century has been characterized by a continuing crescendo of tragedy. In the years since I first entered college, the country has faced a steady drumbeat of crisis. We have seen our institutions threatened by widespread hunger, unemployment and war. We have overcome or mitigated many of those earlier problems and have learned to cope with others. But, it is dispiriting that, at a time of unparalleled affluence and increased opportunity for so many, we are facing grave problems which threaten our society as seriously as bankruptcy and depression did in the early thirties and, as then, seem to defy solution. Fortunately, our traditions and institutions reflect a history of success in coping with the difficulties and problems of each generation. Each generation somehow transforms our fears and frustrations into needed reforms.

I believe that we will do so again even though necessary change is, usually, not well received at first. But resistance finally gives way to responsible improvement. It is understandable, but not justifiable, that those of us who are a little timid at the prospect of change from our own well ordered lives refuse to face up to the admitted needs and inadequacies of our society. Nevertheless, we must be prepared to make some adjustments and, in some cases, sacrifices.

By this time most of you must be wondering what all this has to do with our meeting. Apart from the fact that I wished to philosophize a little, I do feel that the great changes now taking place already have had important effects on our industrial and financial life. The changes to come will have greater effects.

We are experiencing revolutions in nearly every aspect of our life: our schools, our governments, our dress, our music, our corporate institutions and our securities markets. In the over-all scheme of things, the change in our corporate institutions and in the securities markets may not seem as significant as the revolutions in the ghettoes, on campus or in outer space. But, regardless of how the ferment in the securities markets compares with changes in other important areas, there is no doubt that we are experiencing a revolution in terms of volume and sources of business, in the functioning of the markets, in the flow of capital and in the impact of all of this on investors, institutions, public companies and the economy generally. These developments, and solutions to the problems they have generated, are as important to the well being of our country as are solutions to some of the more obvious problems flowing from the other revolutions going on around us.

It may appear too facile to suggest that this is all "part of one great pattern", but I am convinced there is a relationship, that there is but one great convulsion through which our society is now struggling, that these changes are reflections of post-industrial revolution pains and that they are of a rather serious character. There is a momentum which spills over and interacts from one area to another. Problems in our interdependent society are not as easily isolated as in earlier times.

In summary, these are most unusual times -- and the special corner of our society which we are gathered here to discuss is as incredible in its growth and portent for change as any other. I will list a few benchmarks.

Today institutions hold $260 billions or 34 percent of the total stock outstanding compared to $65 billion or 23 percent a little over ten years ago. Just over $50 billion or 26 percent of this increase reflected the expansion of pension fund stock holdings; investment companies accounted for another $44 billion or 23 percent of the increase; and the rumblings we hear from the insurance companies and the banks indicate that, if anything, we can expect the growth in institutional holdings to continue indefinitely and, possibly, to accelerate. The entrance of the insurance companies into the fund field adds an additional sales force potential of 200,000 to the 50,000 salesmen and brokerage representatives now selling fund shares. These salesmen have access to 130,000,000 life insurance policyholders. By way of comparison, there are 5,000,000 Americans who own mutual fund shares.

The institutional share of volume on the New York Stock Exchange grew from 24 percent in 1960 to 33 percent in 1966. But from 1966 to the third quarter of 1968 it would appear that the institutional share of total volume has expanded sharply and now may very well approximate 50 percent. Turnover rates for mutual funds have risen from 19 percent in 1965 to 43 percent in 1968. Although not quite as dramatic, turnover ratios of other institutions, including pension funds and insurance companies, have risen steadily as well. This was something that we knew was happening and it was this kind of growth in institutional activity which prompted members of Congress to propose an SEC study.

There are other indications of the dramatic change that is occurring in the composition of our stock markets in the last few years. There were over 40 instances in the first quarter of 1968 in which a single investment company accounted for 25 percent or more of the purchase volume in a single stock. Other statistics which we have been receiving recently show that some investment companies are turning over their portfolios with extreme rapidity. This is not new either, but what is new, at least to us, is the knowledge that this is not just one or two or five funds but that there now are many investment companies with very high rates of portfolio turnover. For example, in the third quarter of 1968, there were 14 funds having annualized turnover rates of 100 percent or more. In other words, their portfolios were turned over at a rate which, if carried on for the whole year, would result in at least one complete change in portfolio every year. On this basis, there were 44 funds with turnover rates of 50 percent or greater. It is small wonder that people talk about strains on our market mechanisms.

Now what does this all really mean for the markets, those who use the markets and our industrial economy? I don't know. I am awed (but not, I must emphasize, <u>over</u>awed) by the enormity and the potential of institutional growth. I am concerned that the structures of our corporate economy and our markets are changing so quickly that we do not fully understand what is happening and do not have the means to assess the implications. I am convinced, however, that our markets must be equipped to meet the challenges ahead -- the current inability to deal adequately with the simple bookkeeping chores is a disquieting example of current inadequacy -- and that the regulatory response to the developments now taking place, and those we can reasonably anticipate, must be adequate to deal with the new problems which, history demonstrates, are the inevitable result of dramatic and unexpected change. We cannot rely on a hope and a prayer to meet the challenges of rapidly changing markets, of growing institutionalization and concentration of industrial and financial power, of greater public participation directly, or indirectly through financial intermediaries, in American industry and in the markets, of choked trading facilities, and of the greater public responsibilities all of this places on us.

You have just heard me go through a list of rather impressive figures -- figures which merely stress what most of you already know: 1) that institutions are growing at a pace unforseen just a few years ago -- and every indication is that this trend will continue; 2) that turnover and volume are exceeding all predictions; 3) that the form of corporate enterprise is experiencing rapid and radical change; 4) that our market mechanisms are already extraordinarily strained by all of this activity; 5) that traditional notions of money management are giving way to strategies which involve, on the one hand, opportunities for great rewards but, on the other, substantially greater risk, and 6) that we know only in the vaguest way what all this means and where we are going -- how this relates to other economic phenomena and what kinds of policy (economic and regulatory) are required to cope successfully with these changes.

It is not enough to say that these are difficult and complex problems.

To deal with some of these problems -- to define them so that we do understand them -- the Commission has just launched the Institutional Investment Study. This Study is sponsored by Congress -- not, as the name may imply, by our hosts. We have, as you know, recently chosen a director for the Study - Professor Donald E. Farrar - who is attending your meetings with some of his colleagues. We have completed the selection of an Advisory Committee and are rapidly developing a staff of outstanding young lawyers and economists for the Study.

Although I would not want in any way to restrict a more precise formulation by the Commission of the study outlined by Prof. Farrar, on the basis of preliminary discussions with him and other persons, it appears that at least four general types of analyses are anticipated. To place the activity of institutional investors in perspective, there would be background analyses of savings flows, asset holdings, and aggregate trading activity. Out of these studies we may improve somewhat both the coverage, the precision and the detail of the overall statistics.

Institutions have developed over a relatively long period of time and the long-term trends in their development undoubtedly reflect the greater efficiency with which they can invest the savings of individuals by providing greater diversification and expertise. Institutions themselves appear also to be changing in terms of the types of portfolios they hold and in terms of their turnover of those portfolios. These factors may represent broad underlying economic policies. It is against the background of important federal policies, such as those reflected in current views as to taxation and home ownership, and within the context of a divessity of views concerning safe and unsafe rates of inflation, that the long-term trends and shifts to institutionalized savings must be considered. It is not clear that we will be able to explore adequately or at all certain of the changes in these fields. It is my understanding that other agencies or institutions have initiated or are planning studies which will complement ours. What is clear is that thorough analyses of long-term and emerging trends in the context of broad federal policies will be necessary to place in perspective current developments in the equities markets.

A second type of activity would involve a comparative analysis of particular types of institutions, their growth, their behavior, the types of risks which they are prepared to take, the types of transactions which characterize their market activities, and perhaps a cross section view of their assets. While some studies have been done of particular types of institutions, and I am thinking now in particular of life insurance companies, the focus of those studies has been not on equity investment but rather on their holdings and management of debt securities which in the past have been more important for those institutions. We plan to concentrate much more on their activities in the equities markets, their objectives in equity investment and generally, the ways in which they arrive at their investment decisions. The effort in this area would be somewhat greater than the first set of analyses; but they may be less important than the third general set of analyses which I would refer to as Market Studies.

The market impact studies would include analyses of such things as:

(1) The volatility of stock prices associated with more or less institutional participation;
(2) The types of transactions that are used by institutional investors and the different types of price impact they would or could have;
(3) Analyses of transactions costs of institutions as compared to those of other investors;
(4) Analyses of institutional liquidity needs and the extent to which those liquidity needs may affect the investment practices of institutions and the stock

market; and

(5) The adjustments that are being made now or which may be required, in stock market mechanisms to absorb block transactions or to distribute blocks of stock to other investors.

There would be a fourth set of analyses designed to evaluate the effect of institutional growth and investment on the securities industry and on corporate management. This part of the study would analyze the sensitivity of capital costs, capital structures, and dividend and other policies of portfolio companies to institutional shareholders. An evaluation also would be made of tax questions as they relate to institutional transactions, corporate repurchases of their own stock, conglomeration, and the use of the external financial markets to finance mergers.

Finally, we cannot overlook the millions of people who are affected by this tendency toward increasing institutionalization. The individual investor, and we still have about 25 million of those, must not be trampled by the activity of the onrushing giants. And, of course, the giants are merely collections of other millions of investors in funds, pension and profit sharing plans, and others concerned or affected by the growth of foundations the future of all of these lies in the hands of a relatively few investment managers who are rapidly changing conventional and traditional modes and objectives of investment management.

These problems are exciting, important and unlikely to be completely answered by the Study. We are hopeful, however, that the Study will provide vitally needed information, presently either unavailable or not systematically collected, so that we can deal more effectively with the many important questions clearly raised by the explosive growth of the institutions and their special ways of doing business.

Other studies are under way, or on the planning boards, which will deal with other markets -- the money markets, the mortgage markets -- and with some of the related social and cultural changes. Hopefully, the combined efforts of the Commission, and of others embarking on or planning studies, will produce a fund of knowledge and a continuing flow of relevant data, as a basis for further study and analysis by scholars and by hard headed businessmen.

Our study is basically an economic study not an enforcement venture -- but it is more than an academic exercise in fact gathering. We cannot indulge in the luxury of the law professor who, in the socratic tradition, advised his classes: "I am not here to answer questions, merely to raise them". The stakes are very high -- we require answers, reasoned answers, based on facts, based on realities. Not only must we have analysis and recommendations, they must be put in clear understandable terms and explained so that mere lawyers, commissioners and other ordinary citizens can understand them.

To succeed, this Study must have the cooperation of the institutions-- your cooperation. I dare say you want some of these questions answered at least as much as we do. Intelligent understanding, and any necessary regulation, can be achieved through cooperative effort. I would ask you to join us in this effort. Your enlightened self-interest is served by a well functioning securities market. We are confident this Study will help us achieve that goal.